



STATE OF WASHINGTON

ECONOMIC AND REVENUE FORECAST COUNCIL

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February 28, 2005

TO: Governor's Council of Economic Advisors

FROM: ChangMook Sohn, Executive Director
Economic and Revenue Forecast Council

SUBJECT: PRELIMINARY FEBRUARY ECONOMIC FORECAST

This preliminary forecast was based on Global Insight's February Control forecast for the U.S. economy. You should have received a summary of the Global Insight forecast by email. If not, please contact our office. The forecast incorporated the advance GDP estimate for the fourth quarter of 2004. According to the advance estimate, real GDP grew at a 3.1 percent rate in the fourth quarter of 2004, down from 4.0 percent in the third quarter. While domestic demand remained strong in the fourth quarter, trade deteriorated sharply. Payroll employment growth improved to 1.7 percent in the fourth quarter from 1.2 percent in the third quarter while the unemployment rate held steady at 5.43 percent. According to the Bureau of Economic Analysis, the \$3.00 per share special dividend Microsoft paid in December 2004 added \$99.4 billion (annual rate) to U.S. personal income in the fourth quarter which was almost exactly the assumption made in earlier forecasts. As expected in the forecast, the Federal Reserve raised its target rate 25 basis points to 2.50 percent in February. Overall, the new national forecast is somewhat stronger than the forecast adopted in November in most respects including GDP, employment, and income growth.

A comparison of the preliminary U.S. forecast with the forecast adopted in November is shown in Table 2.

The Washington State forecast reflects the slightly stronger growth in the new U.S. forecast. The Washington aerospace employment forecast assumes stronger growth than in November, primarily in 2005. By the first quarter of 2006 aerospace employment is 3,500 higher than in the November forecast. That difference is maintained through the end of 2007. The forecast now expects an increase of 15,300 from the fourth quarter of 2004 to the fourth quarter of 2007. The software wage forecast assumes a somewhat lower trend and a sharper increase every third quarter when stock awards vest and bonuses are paid at Microsoft. Microsoft stock options are expected to continue to decline but income from stock grants will grow. Software employment is expected to increase 5,500 during the next three years compared to 6,400 in the November

forecast. As in November, the forecast reflects the AT&T Wireless-Cingular merger. The forecast assumes a total reduction of 2,500 during the last three quarters of 2005.

The November forecast for Washington personal income included the special \$3.00 Microsoft dividend which was paid in December. At that time we assumed Washington would be credited with its proportionate share of the U.S. total (about 2 percent) since there was no way to determine exactly how much would go to each state. Moreover, since the bulk of Washington's share would go to a few very large shareholders, we felt the economic impact was minimal. Since then, the Bureau of Economic Analysis has made it clear that it will attempt to identify officers, board members, and certain other Washington residents who hold large amounts of Microsoft stock and ascribe their dividend income to Washington. We estimate that this will add \$21.320 billion (annualized) to personal income in the fourth quarter in addition to the \$2.126 billion already accounted for by the model for a total of \$23.446 billion.

This forecast also incorporates newly available Covered Employment and Payrolls (ES-202) data for the third quarter of 2004. The benchmark revision to the third quarter subtracted 6,800 from the level of employment in September. However, employment growth from September through January was 800 more than expected. The combined effect was a 6,000 reduction in the estimate for January. The ES-202 data also indicate that third quarter wages were \$2.275 billion higher than expected in November. Software wages were \$0.314 billion lower than expected. Non-software wages, however, were \$2.589 billion higher. Nonwage personal income was \$0.074 billion above the November estimate. The revision to total personal income in the third quarter was an increase of \$2.350 billion. The forecast also reflects Seattle consumer price data through December, which continues to show local inflation running well below the national average. Seattle's over-the-year core inflation was a 0.9 percent compared to 2.3 percent for the U.S. city average. The number of housing units authorized by building permit jumped to 56,100 in the fourth quarter from 50,900 in the third quarter. Housing has not been this strong in Washington since 1990.

The large increase to the wage and personal income estimates for the third quarter of 2004 are mostly due to a sharp increase in a new data source which attempts to capture stock option income as well as corporate officer income. These data jumped 55 percent from \$4.3 billion dollars (annual rate) in the second quarter of 2005 to \$6.7 billion in the third quarter. There were suspiciously large increases in several sectors. We are concerned about the accuracy of this new data source. If the third quarter jump was not real, Washington wages and personal income could be overstated by more than \$2 billion.

A comparison of the preliminary Washington forecast with the forecast adopted in November is shown in Table 3. A comparison that excludes the \$21.320 billion Microsoft dividend adjustment is shown in Table 3A.

Review of the forecast by the Governor's Council of Economic Advisors is scheduled for Friday March 4 at 10:00 a.m., in the **Governor's Conference Room**.

If you have any questions, please contact Bret Bertolin, Senior Economic Forecaster, at (360) 570-6106.

PLEASE NOTE:

Enclosed is a worksheet summarizing the preliminary forecast. **Council members are strongly encouraged to complete and return this worksheet either in person at the Governor's Council meeting or, if unable to attend, by FAX to (360) 753-7022.** This worksheet is relied on by the Forecast Council members and staff to gauge the reasonableness of the preliminary economic forecast and also serves as the basis of an alternative economic and revenue forecast.

Fluctuations in software wages cause significant distortions in overall wage and personal income trends. In addition, Microsoft's special \$3.00 dividend causes a distortion in income growth in the fourth quarter of 2004, first quarter of 2005, and calendar years 2004 and 2005. The following table shows what growth would have been without these factors.

	2005:1	2005	2006	2007:1,2
<u>Washington Real Personal Income, %Ch.</u>				
Baseline	-30.3	1.8	4.2	3.5
Excluding Software & Dividend	5.1	4.8	4.2	4.1
Difference	-35.4	-2.9	0.1	-0.7
<u>Washington Average Annual Wage, %Ch.</u>				
Baseline	3.5	4.6	4.5	3.6
Excluding Software & Dividend	4.3	4.9	4.4	4.9
Difference	-0.8	-0.4	0.1	-1.3

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Enclosures

Table 1
U.S. Economic Forecast Comparison
February 2005

	2004Q4	2005Q1	2005Q2	2005Q3	2004	2005	2006	2007
Real GDP, Percent Change								
Global Insight	3.1	3.6	3.7	3.3	4.4	3.5	3.1	3.2
Blue Chip	3.1	3.5	3.6	3.5		3.6	3.4	
Economy.com	3.1	3.3			4.4	3.5		
S&P	3.2	4.0	4.2	3.4	4.4	3.7	3.3	3.2
Merril Lynch	3.1	3.2	3.0	2.7	4.4	3.2	3.3	
Federal Funds Rate								
Global Insight	1.95	2.44	2.91	3.14	1.35	2.98	3.60	4.07
Blue Chip*	2.1	2.6	3.0	3.5		3.1	4.1	
Economy.com	1.95	2.45			1.35	2.97		
S&P	2.0	2.4	2.9	3.1	1.3	3.0	4.0	4.0
Consumer Price Index, Percent Change								
Global Insight	3.4	1.6	0.7	1.0	2.7	2.0	1.6	2.0
Blue Chip	3.4	2.0	2.2	2.2		2.5	2.3	
Economy.com	3.4	1.7			2.7	2.3		
S&P	3.4	1.6	0.7	1.1	2.7	2.0	1.7	2.2
Merril Lynch	3.4	1.4	1.5	1.5	2.7	2.1	1.8	
Payroll Employment, Millions								
Global Insight	132.3	132.8	133.4	134.0	131.5	133.7	135.5	136.9
Economy.com	132.3	132.8			131.5	133.8		
S&P	132.3	132.8	133.5	134.1	131.5	133.8	135.8	137.3
Unemployment Rate, Percent								
Global Insight	5.43	5.27	5.18	5.13	5.53	5.19	5.23	5.19
Blue Chip	5.4	5.3	5.3	5.2		5.3	5.2	
Economy.com	5.4	5.2			5.5	5.3		
S&P	5.4	5.2	5.1	5.1	5.5	5.1	5.1	5.0
Merril Lynch	5.4	5.5	5.4	5.4	5.5	5.4	5.4	
Real Disposable Personal Income, Percent Change								
Global Insight	8.4	-1.2	3.8	2.8	3.4	2.8	3.2	3.1
Blue Chip	8.4	1.3	3.6	3.6		3.3	3.5	
Merril Lynch	8.4	3.8	4.0	4.0	3.4	3.3	3.8	

* Estimate based on T-bill rate.

Table 2

U.S. Forecast Comparison

	2004Q2	2004Q3	2004Q4	2005Q1	2005Q2	2005Q3	2003	2004	2005	2006	2007
Real GDP (Billions of Chained 2000 Dollars)											
February	10784.7	10891.0	10975.7	11074.0	11176.4	11267.9	10381.3	10837.2	11214.0	11564.8	11939.1
Percent Change	3.3	4.0	3.1	3.6	3.7	3.3	3.0	4.4	3.5	3.1	3.2
October	10784.7	10895.2	10985.7	11081.6	11176.9	11256.7	10381.3	10840.8	11211.4	11541.1	11910.2
Percent Change	3.3	4.2	3.4	3.5	3.5	2.9	3.0	4.4	3.4	2.9	3.2
Implicit Price Deflator (2000=1.000)											
February	1.077	1.080	1.087	1.090	1.092	1.096	1.055	1.078	1.095	1.112	1.136
Percent Change	3.1	1.3	2.5	1.2	1.0	1.2	1.9	2.2	1.5	1.6	2.1
October	1.077	1.080	1.085	1.089	1.094	1.098	1.055	1.078	1.096	1.114	1.135
Percent Change	3.1	1.2	1.8	1.7	1.6	1.4	1.9	2.1	1.7	1.7	1.9
Real Personal Income (Billions of Chained 2000 Dollars)											
February	8908.3	8955.9	9132.2	9135.7	9229.1	9321.3	8683.0	8958.8	9268.0	9605.3	9924.2
Percent Change	3.2	2.2	8.1	0.2	4.2	4.1	1.3	3.2	3.5	3.6	3.3
October	8899.6	8951.2	9117.3	9119.0	9200.1	9278.3	8683.0	8951.7	9235.9	9548.1	9861.0
Percent Change	2.8	2.3	7.6	0.1	3.6	3.4	1.3	3.1	3.2	3.4	3.3
Wage and Salary Employment											
February	131.33	131.73	132.29	132.75	133.45	134.00	130.00	131.47	133.67	135.49	136.93
Percent Change	2.4	1.2	1.7	1.4	2.1	1.7	-0.3	1.1	1.7	1.4	1.1
October	131.12	131.48	131.99	132.66	133.33	133.84	129.94	131.24	133.50	134.96	136.16
Percent Change	2.3	1.1	1.6	2.1	2.0	1.5	-0.3	1.0	1.7	1.1	0.9
Unemployment Rate											
February	5.57	5.43	5.43	5.27	5.18	5.13	5.99	5.53	5.19	5.23	5.19
October	5.60	5.43	5.37	5.31	5.29	5.33	5.99	5.51	5.33	5.53	5.61
Mortgage Rate											
February	6.13	5.90	5.73	5.84	6.03	6.14	5.82	5.84	6.09	6.46	6.76
October	6.13	5.90	5.96	6.08	6.06	6.23	5.82	5.90	6.18	6.58	6.75
3 Month T-Bill Rate											
February	1.07	1.48	2.00	2.47	2.90	3.12	1.01	1.36	2.96	3.40	3.76
October	1.07	1.49	1.88	2.21	2.51	2.75	1.01	1.34	2.59	3.18	3.26

Table 3

Washington Forecast Comparison

	2004Q2	2004Q3	2004Q4	2005Q1	2005Q2	2005Q3	2003	2004	2005	2006	2007
Real Personal Income (Billions of Chained 2000 Dollars)											
February	198.099	200.443	222.921	203.713	205.676	210.850	193.306	203.899	207.645	216.425	225.268
Percent Change	8.4	4.8	53.0	-30.3	3.9	10.4	0.9	5.5	1.8	4.2	4.1
October	196.763	198.295	201.543	201.762	203.724	206.440	193.306	197.700	204.881	213.207	222.011
Percent Change	5.4	3.2	6.7	0.4	3.9	5.4	0.9	2.3	3.6	4.1	4.1
Personal Income											
February	213.310	216.511	242.256	222.017	224.689	231.033	203.956	219.880	227.334	240.787	255.828
Percent Change	11.8	6.1	56.7	-29.5	4.9	11.8	2.8	7.8	3.4	5.9	6.2
October	211.871	214.162	218.669	219.814	222.832	226.602	203.956	213.054	224.500	237.482	252.101
Percent Change	8.7	4.4	8.7	2.1	5.6	6.9	2.8	4.5	5.4	5.8	6.2
Wage and Salary Employment											
February	2697.2	2704.7	2714.0	2732.9	2749.2	2765.0	2657.8	2697.8	2755.1	2803.7	2854.2
Percent Change	3.3	1.1	1.4	2.8	2.4	2.3	0.1	1.5	2.1	1.8	1.8
October	2699.6	2714.1	2724.7	2738.5	2752.0	2763.3	2658.0	2703.5	2756.8	2801.9	2848.8
Percent Change	3.7	2.2	1.6	2.0	2.0	1.7	0.2	1.7	2.0	1.6	1.7
Manufacturing Employment											
February	263.1	263.9	265.2	269.2	270.9	273.3	267.0	263.6	272.3	280.0	288.1
Percent Change	1.4	1.2	2.0	6.2	2.5	3.7	-6.3	-1.3	3.3	2.8	2.9
October	262.0	262.0	264.2	265.8	267.5	268.3	266.7	262.3	267.8	275.1	281.9
Percent Change	1.6	-0.1	3.4	2.4	2.5	1.2	-6.4	-1.6	2.1	2.7	2.5
Construction Employment											
February	163.8	163.4	165.1	165.8	167.2	167.9	156.2	163.4	167.2	169.6	172.9
Percent Change	5.7	-0.8	4.1	1.8	3.4	1.8	1.3	4.6	2.3	1.4	1.9
October	163.7	164.0	165.2	166.8	167.8	168.1	156.1	163.6	167.9	170.4	173.6
Percent Change	5.4	0.7	3.1	4.0	2.3	0.6	1.2	4.8	2.6	1.5	1.9
Housing Permits											
February	46.801	50.898	56.063	50.361	48.148	46.874	42.825	49.247	47.743	44.548	44.003
Percent Change	37.4	39.9	47.2	-34.9	-16.4	-10.2	6.5	15.0	-3.1	-6.7	-1.2
October	46.456	50.653	46.491	46.192	45.633	45.105	42.825	46.402	45.298	42.699	42.841
Percent Change	49.6	41.3	-29.0	-2.5	-4.8	-4.5	6.5	8.4	-2.4	-5.7	0.3

Table 3A

Washington Forecast Comparison Excluding Microsoft Dividend Adjustment

	2004Q2	2004Q3	2004Q4	2005Q1	2005Q2	2005Q3	2003	2004	2005	2006	2007
Real Personal Income (Billions of Chained 2000 Dollars)											
February	198.099	200.443	203.303	203.713	205.676	210.850	193.306	198.995	207.645	216.425	225.268
Percent Change	8.4	4.8	5.8	0.8	3.9	10.4	0.9	2.9	4.3	4.2	4.1
October	196.763	198.295	201.543	201.762	203.724	206.440	193.306	197.700	204.881	213.207	222.011
Percent Change	5.4	3.2	6.7	0.4	3.9	5.4	0.9	2.3	3.6	4.1	4.1
Personal Income											
February	213.310	216.511	220.936	222.017	224.689	231.033	203.956	214.550	227.334	240.787	255.828
Percent Change	11.8	6.1	8.4	2.0	4.9	11.8	2.8	5.2	6.0	5.9	6.2
October	211.871	214.162	218.669	219.814	222.832	226.602	203.956	213.054	224.500	237.482	252.101
Percent Change	8.7	4.4	8.7	2.1	5.6	6.9	2.8	4.5	5.4	5.8	6.2
Wage and Salary Employment											
February	2697.2	2704.7	2714.0	2732.9	2749.2	2765.0	2657.8	2697.8	2755.1	2803.7	2854.2
Percent Change	3.3	1.1	1.4	2.8	2.4	2.3	0.1	1.5	2.1	1.8	1.8
October	2699.6	2714.1	2724.7	2738.5	2752.0	2763.3	2658.0	2703.5	2756.8	2801.9	2848.8
Percent Change	3.7	2.2	1.6	2.0	2.0	1.7	0.2	1.7	2.0	1.6	1.7
Manufacturing Employment											
February	263.1	263.9	265.2	269.2	270.9	273.3	267.0	263.6	272.3	280.0	288.1
Percent Change	1.4	1.2	2.0	6.2	2.5	3.7	-6.3	-1.3	3.3	2.8	2.9
October	262.0	262.0	264.2	265.8	267.5	268.3	266.7	262.3	267.8	275.1	281.9
Percent Change	1.6	-0.1	3.4	2.4	2.5	1.2	-6.4	-1.6	2.1	2.7	2.5
Construction Employment											
February	163.8	163.4	165.1	165.8	167.2	167.9	156.2	163.4	167.2	169.6	172.9
Percent Change	5.7	-0.8	4.1	1.8	3.4	1.8	1.3	4.6	2.3	1.4	1.9
October	163.7	164.0	165.2	166.8	167.8	168.1	156.1	163.6	167.9	170.4	173.6
Percent Change	5.4	0.7	3.1	4.0	2.3	0.6	1.2	4.8	2.6	1.5	1.9
Housing Permits											
February	46.801	50.898	56.063	50.361	48.148	46.874	42.825	49.247	47.743	44.548	44.003
Percent Change	37.4	39.9	47.2	-34.9	-16.4	-10.2	6.5	15.0	-3.1	-6.7	-1.2
October	46.456	50.653	46.491	46.192	45.633	45.105	42.825	46.402	45.298	42.699	42.841
Percent Change	49.6	41.3	-29.0	-2.5	-4.8	-4.5	6.5	8.4	-2.4	-5.7	0.3

Advisor's Name: _____

Forecast Worksheet
February 28, 2005

	2005:Q1	2005	2006	Average 2007:1,2
<u>U.S.</u>				
Real GDP, %Ch				
Baseline	3.6	3.5	3.1	3.3
Your Opinion	_____	_____	_____	_____
Implicit Price Deflator, % Ch				
Baseline	1.2	1.5	1.6	2.1
Your Opinion	_____	_____	_____	_____
Mortgage Rate, Percent				
Baseline	5.8	6.1	6.5	6.7
Your Opinion	_____	_____	_____	_____

Washington State

Real Personal Income, % Ch				
Baseline	-30.3	1.8	4.2	3.5
Your Opinion	_____	_____	_____	_____
Wage and Salary Employment, % Ch				
Baseline	2.8	2.1	1.8	1.8
Your Opinion	_____	_____	_____	_____
Manufacturing Employment, % Ch				
Baseline	6.2	3.3	2.8	3.2
Your Opinion	_____	_____	_____	_____
Construction Employment, % Ch				
Baseline	1.8	2.3	1.4	1.8
Your Opinion	_____	_____	_____	_____
Housing Permits (Thousands)				
Baseline	50.4	47.7	44.5	44.0
Your Opinion	_____	_____	_____	_____
Washington Average Annual Wage, % Ch				
Baseline	3.5	4.6	4.5	3.6
Your Opinion	_____	_____	_____	_____